SAUDI ARABIA'S ECONOMIC CHALLENGE

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I. Introduction

Most of the recent attention given to Saudi Arabia has focused on that country's increased level of violence and presumed political stability. However, as Richard Fairbanks has observed, todays headlines obscure tomorrows reality, because he feels it is economics and not politics that will

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determine the stability of the kingdom.[1] In this regard Richard Fairbanks has also noted that the Middle East as a whole is in a race against time. Weak economic performance coupled with slow political evolution remain the Achilles heel of the region's moderate, pro-Western regimes such as Saudi Arabia, Egypt and Bahrain. Whether these regimes survive and prosper will depend primarily on their ability to make their economies grow and broaden popular participation in government and thereby undercut the attraction of extremism.

The expectations of most Saudis have simply outstripped the development and performance of the economy. There have been tremendous gains in educational opportunity and exposure to the international media, but the economic prospects of individuals have generally worsened. In particular, the economy retains all of the problems of an economy remaining overwhelmingly dominated by the petroleum sector.[2] While considerable industrial diversification into non-oil sectors has been achieved, the results, other than those achieved by the Saudi Arabian Basic Industry Corporation (SABIC) have been below expectations. It is apparent that adequate demand can not be maintained without a steady infusion of government expenditures.

In the past, political stability and generous subsidies have been essential to induce local investors to become involved in the economy. The Gulf conflicts, together with slack oil markets, have undermined this approach towards the economy.[3]

The purpose of the analysis below is to examine Saudi Arabia's underlying growth mechanism, and to forecast the consequences of past economic decisions in an attempt to identify what has been lacking in the government's economic policy. The main proposition developed is that in the future the Saudi royal family will have to sustain its legitimacy through demonstrating that it is capable of adapting in ways that are compatible with sustained economic growth. In doing so, the government will have to

1. R. Fairbanks, "The Time Bomb to Watch Is Economic," *Los Angeles Times*, 26 June 1996.
2. See S. Flanders, "The Poverty of Geology", *Financial Times*, 4 December 1995, p. 25; E. Kanovsky, *The Economy of Saudi Arabia: Troubled Present, Grim Future* (Washington, DC: The Washington Institute, 1994); R. E. Looney, "A Post-Keynesian Assessment of Alternative Saudi Arabian Austerity Strategies," *Kuwait University Journal of the Social Sciences, Vol.* 23, No. 3, (Autumn 1995), pp. 251-273.
3. E. Kanovsky, "Middle East Economies and the Arab-Israeli Peace Agreements," *Israel Affairs*, No. 1 (1995), pp. 22-39.

structure its expenditure and liberalization programs in ways that stimulate private sector development and investment.[4] In this regard, increased economic freedom will likely proceed any movement towards political liberalization.[5]

II. Overview

During oil boom years, Saudi Arabia[6] and the other GCC States'[7] economies have been characterized by the lack of binding budgetary constraints which, in turn, has reduced and sometimes even eliminated the need to set spending priorities and allocate scarce economic resources. Financial resources were so large that even with a highly skewed income distribution all sectors of society saw some measure of improvement in their standard of living. Unemployment was unimaginable as governments showed a seemingly infinite capacity to hire both citizens and foreigners in public jobs.

The oil boom created a lasting legacy which in turn is now stifling growth and development in the region. In particular, the oil boom:[8]

- Created a parallel escape from politics in which ruling elites rarely

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4. J. F. Seznec, "The Gulf Capital Markets at a Crossroads," *Columbia Journal of World Business*, Vol. XXX, No. 3 (1995), pp. 6-15.
5. M. F. Field, *Inside the Arab World* (Cambridge: Harvard University Press, 1994).
6. R. E. Looney and P. C. Frederiksen, "The Evolution and Evaluation of Saudi Arabian Economic Planning," *Journal of South Asian and Middle Eastern Studies*, No. 9 (1985), pp. 3-19; M. G. Nehme, "Saudi Development Plans Between Capitalist and Islamic Values," *Middle Eastern Studies*, No. 30 (1994), pp. 632-645; J. Presley and T. Westaway, "Planning in Saudi Arabia," in V. N. Balasubramanyam and J. M. Bates (eds.), *Topics in Policy Appraisal: Case Studies in Economic Development*., Vol. 2 (New York: St. Martin's Press, 1989).
7. K. A. Chaudhry,"The Price of Wealth: Business and State in Labor Remittance and Oil Economies," *International Organization*, No. 43 (1989), pp. 101-146; R. E. Looney, "Saudi Arabia's Development Strategy: Comparative Advantage versus Sustainable Growth," *Orient*, No. 30 (1989), pp. 75-96; M. H. Nagi, "Development With Unlimited Supplies of Capital: The Case of OPEC," *The Developing Economies*, No. XX (1982), pp. 1-19.
8. G. Luciani, "Oil Rent, the Fiscal Crisis of the State and Democratization," in G. Salamé (ed.), *Democracy Without Democrats? The Renewal of Politics in the Muslim World* (London: I.B. Tauris, 1994); V. Zanoyan, "After the Oil Boom," *Foreign Affairs*, Vol. 74, No. 6 (November/December 1995), pp. 2-7.

faced the need to share power, to renew their legitimacy and credibility or tolerate any meaningful public debate over major economic, social or political issues such as oil and budgetary policy.

- Brought about a system which had neither taxation nor representation.

Perhaps the greatest burden imposed by the oil boom years was the creation of an illusion that the oil bonanza would last indefinitely. This has resulted in governments being slow to adapt to the new reality of lower revenues. In particular, governments ran chronic deficits averaging well in excess of 5 percent of GDP, reaching 15 percent in Saudi Arabia. Budget shortfalls were almost entirely reflected in the external accounts, leading to large current account deficits.

In most cases, external and domestic deficits in Saudi Arabia and the Gulf region were initially financed by drawing down the substantial foreign resources accumulated during the 1970s and early 1980s. With exception of the UAE, most Gulf countries depleted their assets and turned to borrowing which for the first time exposed their economies and economic policies to serious international scrutiny. The Saudi government's debt has risen from nearly zero a decade ago to over $90 billion by early 1996.

III. Growth Dilemmas

The problems noted above have received considerable attention in both the popular press and academic literature. The main thesis of this paper is that several more subtle relationships are now jeopardizing the country's longer run economic viability: (1) a change in macroeconomic linkage occurring in the early 1980s; (2) the country's budgetary priorities. These relationships have been compounded by (3) the slow pace of economic reform, particularly reform of financial markets.

(1) Macroeconomic Linkages and Structural Change

Another way of identifying some of the underlying problems currently facing the Saudi authorities is through examining several of the kingdom's key macroeconomic relationships with the use of Granger Causality tests.[9] Tests for structural change[10] indicated that around 1982 several of these linkages were altered. That is the direction of their linkage shifted in a dramatic fashion (*Figures 1* and *2*).

In the period prior to 1982:

- Private investment had a positive impact on non-oil GDP. This relationship was not particularly strong, but it did indicate that the private sector activities were flowing into productive ventures.

- Private investment itself was mainly stimulated by defense expenditures and non-infrastructural investment. Government consumption and infrastructural investment provided considerably less of a stimulus to private investment.

- Non-oil GDP received its strongest stimulus from government consumption, followed by defense expenditures. Ironically, infrastructural investment had a negative impact on the growth in non-oil GDP.

While other researchers[11] have arrived at more optimistic conclusions, in addition to revenue instability,[12] several distinct changes appear to have taken place since 1982; the most important of which was the severing of the link between private investment and non-oil GDP. Non-oil GDP was no longer simulated by defense expenditures or government consumption (*Figure 2*).

Furthermore:

- The only macro variable that had a statistically significant link with non-oil GDP was non-infrastructural investment, and this link was rather weak.

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9. C. W. J. Granger, "Some Recent Developments in a Concept of Causality," *Journal of Econometrics*, No. 39 (1988), pp. 199-211.
10. G. Chow, *Econometrics* (New York: John Wiley & Sons, 1983).
11. M. M. Metwally and M. G. El-Din, "Estimation of Economic Multipliers for Socio-Economic Planning in the GCC Countries," *The Middle East Business and Economic Review*, No. 8 (1996), pp. 49-56.
12. A. M. A. Ghamdi, "Economic Development and Revenue Instability: The Saudi Experience," *METU Studies in Development*, Vol. 19, No. 1(1992), pp. 67-80.

• Private investment's link with defense expenditures weakened during this period, but was still positive. In contrast, the stimulus provided by government consumption strengthened during this period. On the other hand, the earlier stimulus provided by non-infrastructural investment shifted to a negative impact.

• A major change from the earlier period was the shift from private sector investment, affecting private consumption, to that of private consumption providing a stimulus to private investment.

(2) Budgetary Tradeoffs

No doubt part of the declining effectiveness of government expenditures stems from the fact that defense expenditures account for over 30 percent of the Saudi government's budget. However, a more subtle pattern involves the statistically significant manner in which defense expenditures expand at the expense not of human, but instead the country's public economic assets (*Figures 3* and *4*).

• In particular, increases in expected (longer run growth) defense expenditures come largely at the expense of economic services. These reductions carry over to transportation/communication and infrastructure as well.

• These categories are also reduced when the government experiences fiscal stress in the form of unanticipated increases in the fiscal deficit, with economic services also reduced with expansion in the anticipated deficit. However, the kingdom's various subsidies are often funded with unexpected increases in the fiscal deficit.

• Significantly, allocations to human resource development are increased along with expanded defense expenditures.

• In addition to economic services, Saudi Arabia tends to reduce allocations to municipal services and government lending programs during periods of expanded defense expenditures.

For Saudi Arabia, most of the budgetary patterns noted in the short-run carry over to the long term. It should be noted, however, that several of the linkages, while maintaining the same sign as in the short-run, lose their statistical significance in the longer term. Still, many of the key patterns do persist over time (*Figure 4*).

(3) Slow Progress in Economic Reform

One way of overcoming the inhibiting effect on private investment, brought on by the macroeconomic linkage and budgetary effects noted above, would be through the introduction of economic reforms oriented towards creating profitable investment opportunities for the private sector. Unfortunately, reforms of this type have been slow in coming[13] and in many regards the kingdom is lagging behind the progress made in other GCC states (*Figures 5* and *6*).

Although government emphasizes its basic commitment to free enterprise, it maintains a monopoly role in the oil sector and a virtual monopoly in infrastructure development and the provision of most utilities and communications services. Moreover, the government appears to prefer public-private ventures in key heavy industries. On the other hand, the government's recent interest in joining the World Trade Organization (WTO) may signal a move towards liberalization in the trade area.[14]

Lack of innovative reforms, together with the budgetary patterns noted above, have resulted in the kingdom facing severe infrastructure capacity shortages. The main problem is the provision of electricity. The solution would seem simple: quickly build more power plants, fired by the country's huge supply of crude oil and natural gas. As the authorities are discovering, however, the solution is more complicated than that; cash is tight, the government is constrained in tapping domestic capital markets for the required capital markets, and electricity demand is growing three times as fast as the economy. Attempts have also been made to dampen infrastructural demand via tariff increases, but these increases have been insufficient.[15]

While there may be only limited privatization in the near future, the Saudi government is likely to expect private sector to provide a growing proportion of financial support for infrastructure projects:

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13. R. S. Greenberger, C. A., and Robbins, "Succession of Cautious Rulers May Be Slowing Saudi Reform," *Wall Street Journal*, 8 August 1996, p. 7.
14. F. Williams, "Saudis Start Talks on Joining the WTO," *Financial Times*, 3 May 1996.
15. D. Pearl, "Energy Rich Saudi Arabia is Running Low on Electricity," *Wall Street Journal*, 20 August 1996, p. 1.

• One objective, of Sixth Development Plan (1995-99), is to place increased reliance on private sector involvement in capital formation within the kingdom; to contract out some utilities to private sector and sell off parts of the basic industries or another tranche of SABIC - already 30 percent publicly owned.

• Increased use of private capital (estimated US$150 billion) to finance government projects. Much of this capital is currently held outside of the country, with investors waiting for the government to open up public sectors for private investment.

IV. Implications for the Future

The government will be compelled to confront the issue of expatriate-dependence over the next few years. Saudi Arabia is a reluctant host to nearly 5 million expatriates, on whom the country depends for its cheap labor, and almost all of its technical and managerial workforce. Yet because of rapid population growth, rising unemployment among young Saudis is becoming an increasingly contentious issue. Even if oil revenues pick up, there will have to be a major structural change in the environment the private sector operates in, before that sector will be capable of generating self sustained growth and sufficient employment opportunities for the growing Saudi workforce.

More specifically, incorporating the causality and defense analysis summarized above, a twenty two equation macroeconomic policy simulation model was developed.[16] A preliminary vector autoregression forecast to the year 2000 had indicated that in an environment of stable oil revenues, private sector investment would likely contract at an annual average rate of 0.7 percent per annum while the non-oil sector could expand, at most, at about 0.5 percent per annum (based largely on private consumption growing at an annual average rate of 1.2 percent per annum.

One logical way of stimulating growth might be to change budgetary priorities through shifting funds from defense to infrastructure and other growth oriented programs. Recent empirical studies have in fact stressed the

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16. R. E. Looney, *Economic Development in Saudi Arabia: Consequences of the Oil Price Decline* (Greenwitch, Conn: JAI Press, 1990).

general benefits from such fiscal actions.[17] For example Knight et al.[18] finds that because of the growth retarding effects of military spending via its adverse effects on capital formation and resource allocation, a substantial long-run peace dividend could likely stem from budgetary cuts in this area.

While this effect may also apply to Saudi Arabia, the fact that defense expenditures stimulate private investment, minimize to a certain extent any short-term gains stemming from reduced allocations to defense. For example, vector autoregression forecasts to the year 2000 show that holding defense expenditures constant in real terms would only marginally improve the rate of growth in non-oil GDP. Clearly, however, longer run gains are possible and the government should actively explore ways in which non-defense expenditures can substitute for defense as a stimulus to private investment. In this regard, the authorities should seriously consider scale-backing or eliminating its high cost offset program.[19]

Building on this base line forecast, several policy packages were examined: (1) continuation of past expenditure patterns with no major economic reforms; (2) moderate cuts in non-defense expenditures, with stable defense expenditures; and (3) sharp cuts in non-defense expenditures with moderate increases in allocations to defense. In turn, each of these packages was further modified with alternative liberalization/budgetary packages introduced (*Figure 7*).

The main finding of these exercises is that the economy will likely continue to contract throughout the remainder of the 1990s unless the government undertakes serious budgetary/economic reform measures. On the other hand, it is apparent that the economy is capable of fairly strong growth (non-oil GDP in the range of 5-6 percent per annum), given an environment of declining budget and external deficits, together with a major liberalization of the country's capital markets.

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17. J. H. Lebovic and A. Ishaq, "Military Burden, Security Needs, and Economic Growth in the Middle East," *Journal of Conflict Resolution*, Vol. 31, No. 1 (1987), pp. 106-138.
18. M. Knight, N. Loayza, et al., "The Peace Dividend: Military Spending Cuts and Economic Growth," *IMF Staff Papers*, Vol. 43, No. 1, pp. 1-37.
19. C. Thompson, "Planned International Technology Transfer: The Economic Offset Example in Saudi Arabia," *Domes* (1994).

V. Conclusions

Clearly, economic policy during the remainder of the 1990s will be difficult, and will be largely aimed at reducing the twin current-account and fiscal deficits. No doubt the authorities will attempt to do this without introducing new taxes or recourse to direct foreign borrowing. Deficit financing will be undertaken mostly with treasury bills and development bonds, with external borrowing as a last resort. In this regard, government's domestic borrowing will crowd out private investment, making transition to a new growth path difficult, and financing of current account deficits difficult without eventual external public borrowing. Repatriation of private capital is increasingly necessary to finance this gap.[20] Clearly the Saudi royal family's willingness to cooperate with the private sector will be critical in affecting the future course of the economic and political systems.

On the other hand, it is fairly clear that without economic reforms the kingdom's economy will stagnate and be incapable of meeting the demands placed on it by a growing population.[21] The real issue is not whether the kingdom will reform, but how far will it take economic reforms and at what pace.

In this regard, does the future hold any promise for an expanded and more efficient private sector that could play a part in the development of pluralistic politics in the kingdom? There are at least three reasons to be optimistic:[22]

- Saudi society will have to learn how to compete in a highly competitive international economy based on the instantaneous processing of information. Recent technological revolutions and the importance of rapid exchanges of massive amounts of information are incompatible with a state-led economy. Under these conditions, the private sector appears to be well-placed to participate in the

20. F. Moham, "State and Bourgeoisie in the Persian Gulf," *Middle East Report*, No. 22 (1992), pp. 35-37.
21. A. Richards, "Economic Imperatives and Political Systems," *The Middle East Journal*, Vol. 47 (1993), p. 217-227; A. Richards, "Economic Roots of Instability in the Middle East," *Middle East Policy*, Vol. IV, No. 1&2 (1995), pp. 175-187; E. O'Sullivan, "New Era for Middle East Economies," *Middle East Economic Digest*, No. 39 (6 January 1995), pp. 2-3.
22. A. P. Hess, "Peace and Political Reform in the Gulf: The Private Sector," *Journal of International Affairs*, No. 49 (1995), p.103.

country's gradual economic reform process.

• The diversification of the economy has reached a point where the government must consult with the private sector on the breadth and depth of any policy, or, as was the case with the failed Saudi attempt in 1988 to tax foreign businesses, suffer a potentially dangerous state failure.

• Finally, the government will be compelled to expand and rationalize the private sector in view of the already established impact of high rates of population growth, high expectations produced by the oil boom, and the continuing external and internal threats to the state.

Saudi rulers will eventually have to increase the private sector's political space. They will do this first through capital market reforms as in Kuwait, eventually allowing foreign investment and the development of an efficient stock exchange.

Figure 1
Saudi Arabia: Macroeconomic Causality Patterns, 1970-1982

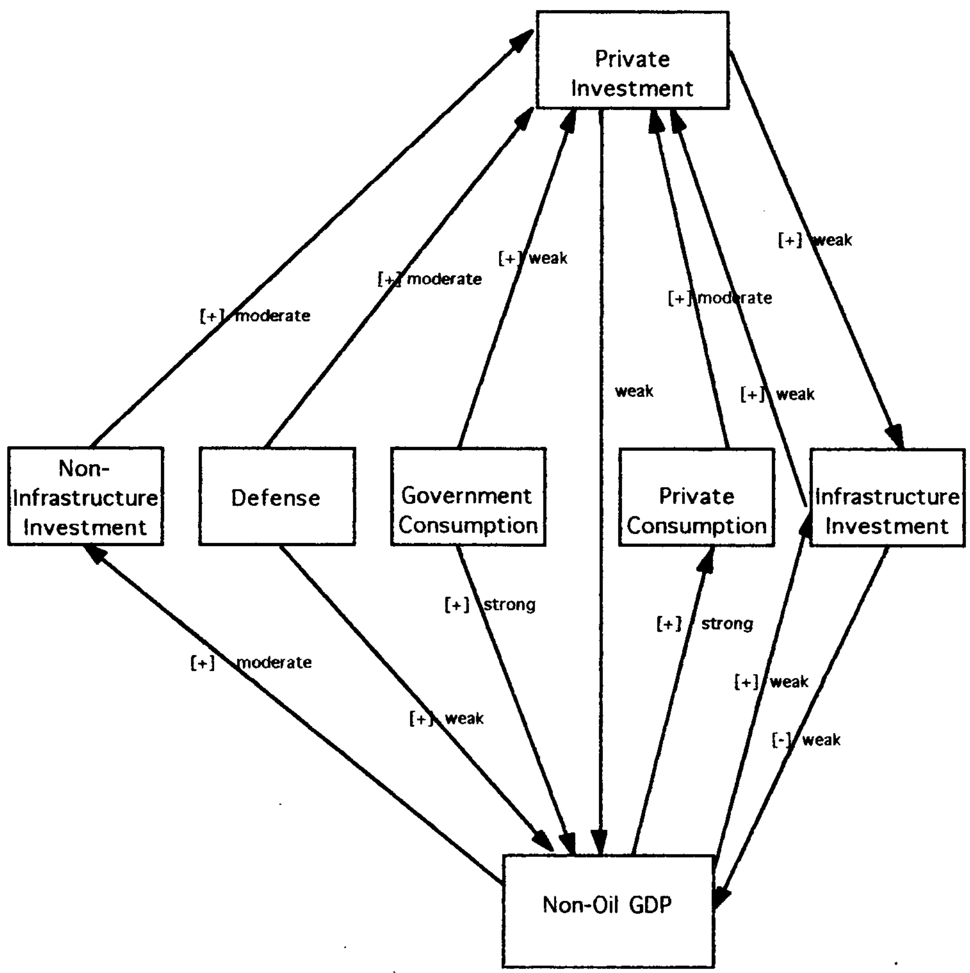


Figure 2
Saudi Arabia: Macroeconomic Causality Patterns, 1980-1992

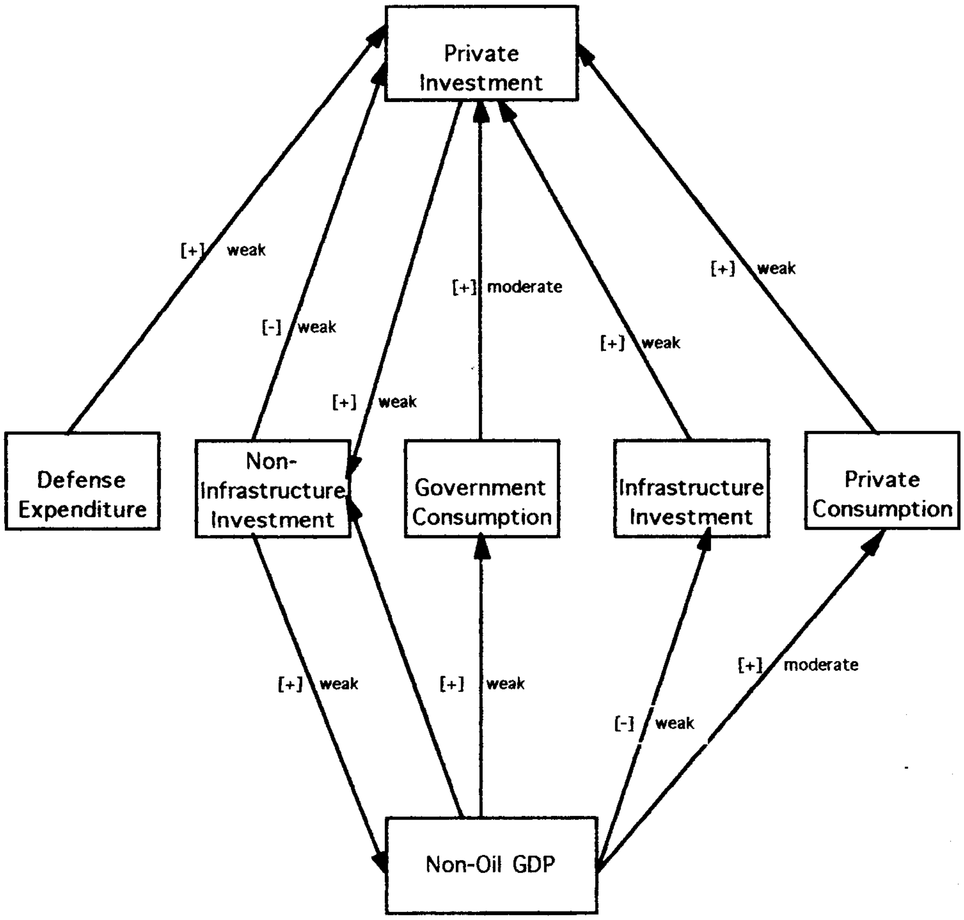
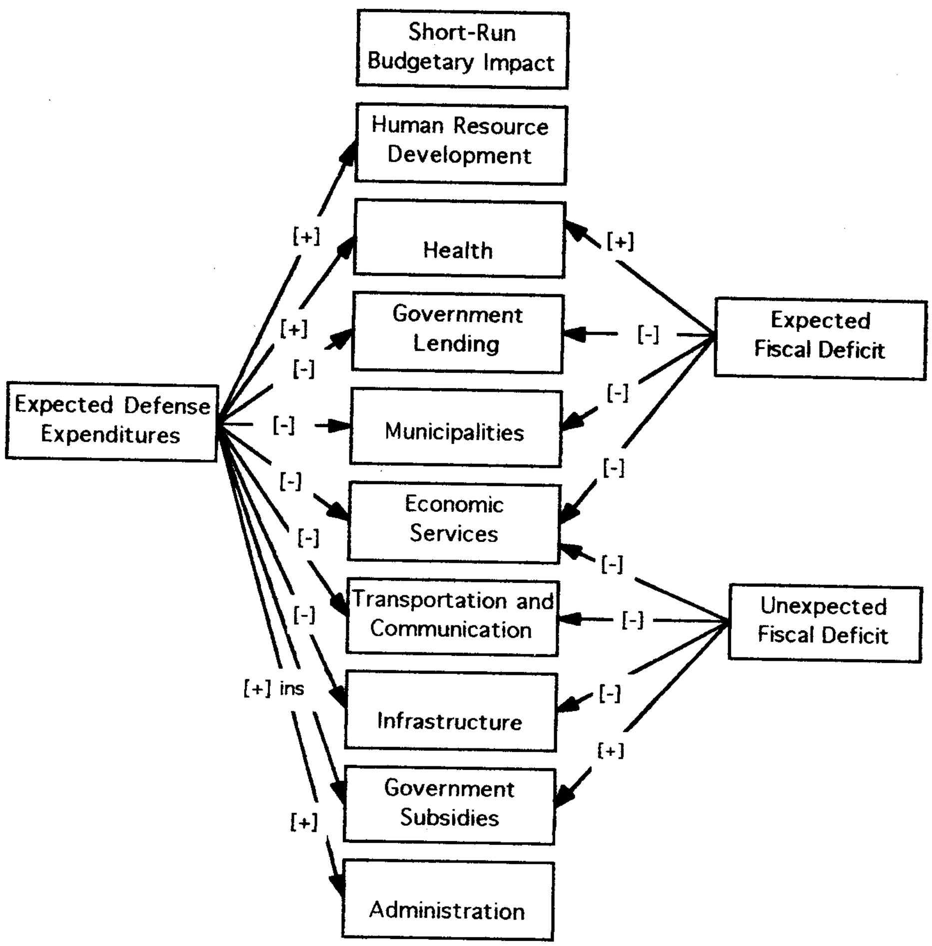
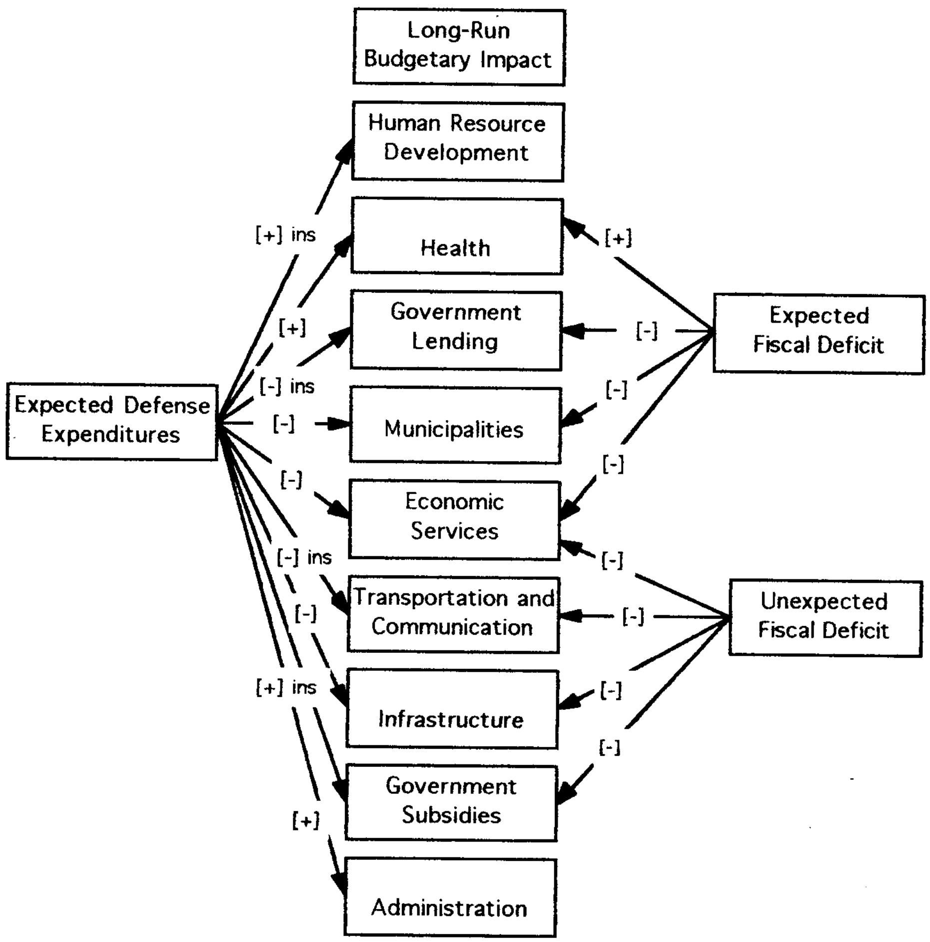


Figure 3
Saudi Arabian Budgetary Patterns:
Short-Run Budgetary Priorities as Defined by
Defense Expenditures and Fiscal Deficits



Note: ins = insignificant.

Figure 4
Saudi Arabian Budgetary Patterns:
Long-Run Budgetary Priorities as Defined by
Defense Expenditures and Fiscal Deficits



Note: ins = insignificant.

Figure 5
GCC States: Progress in Economic Reform

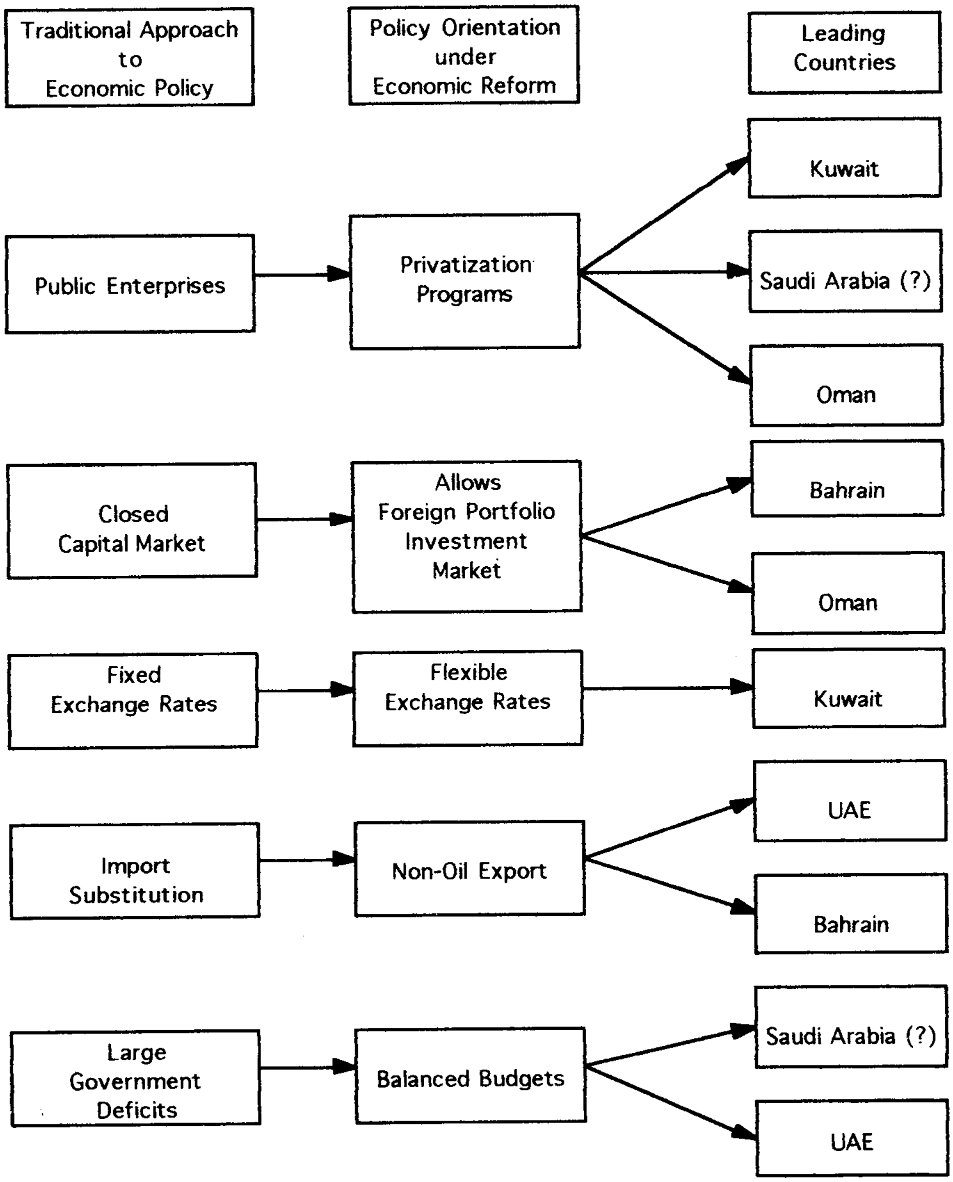
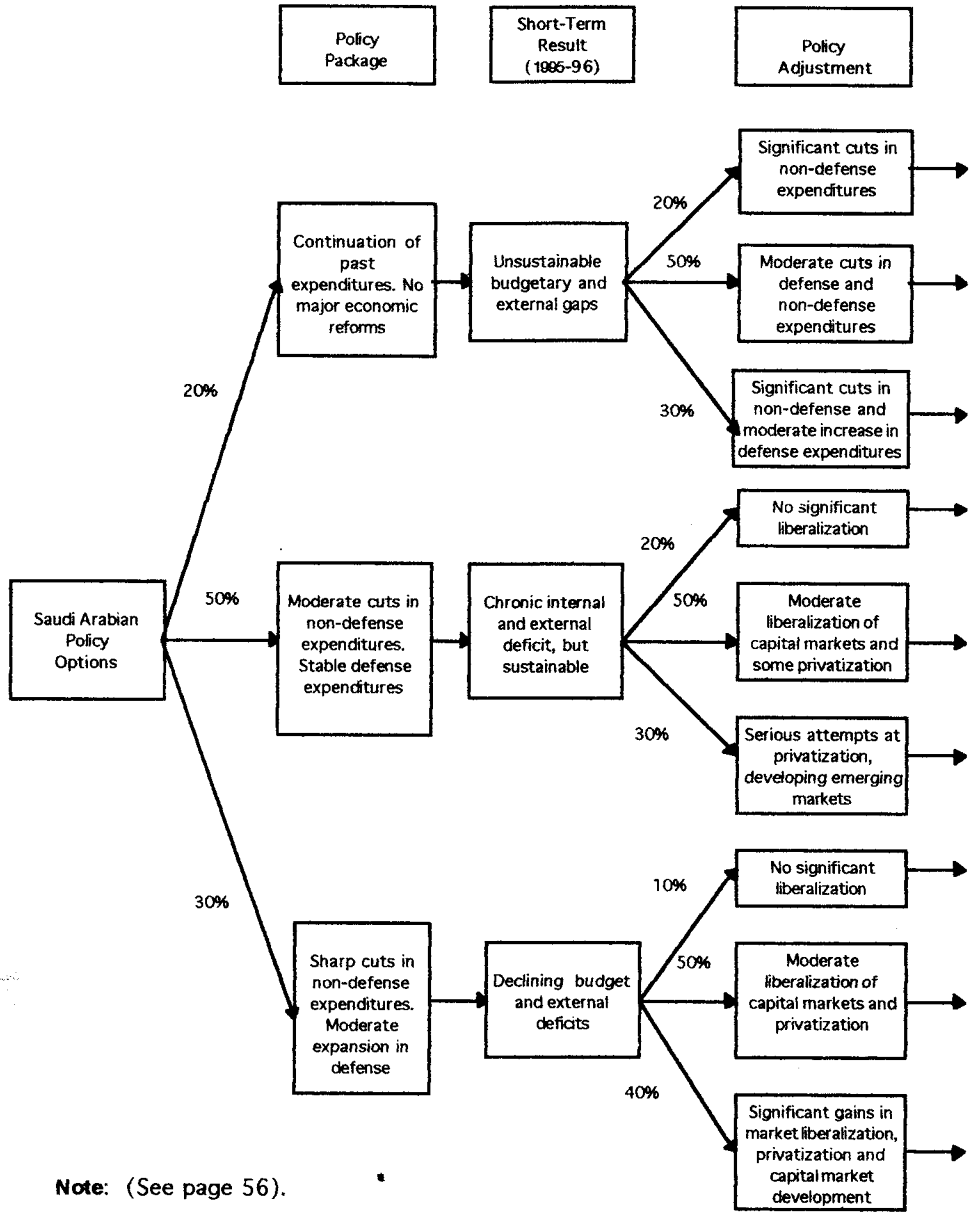


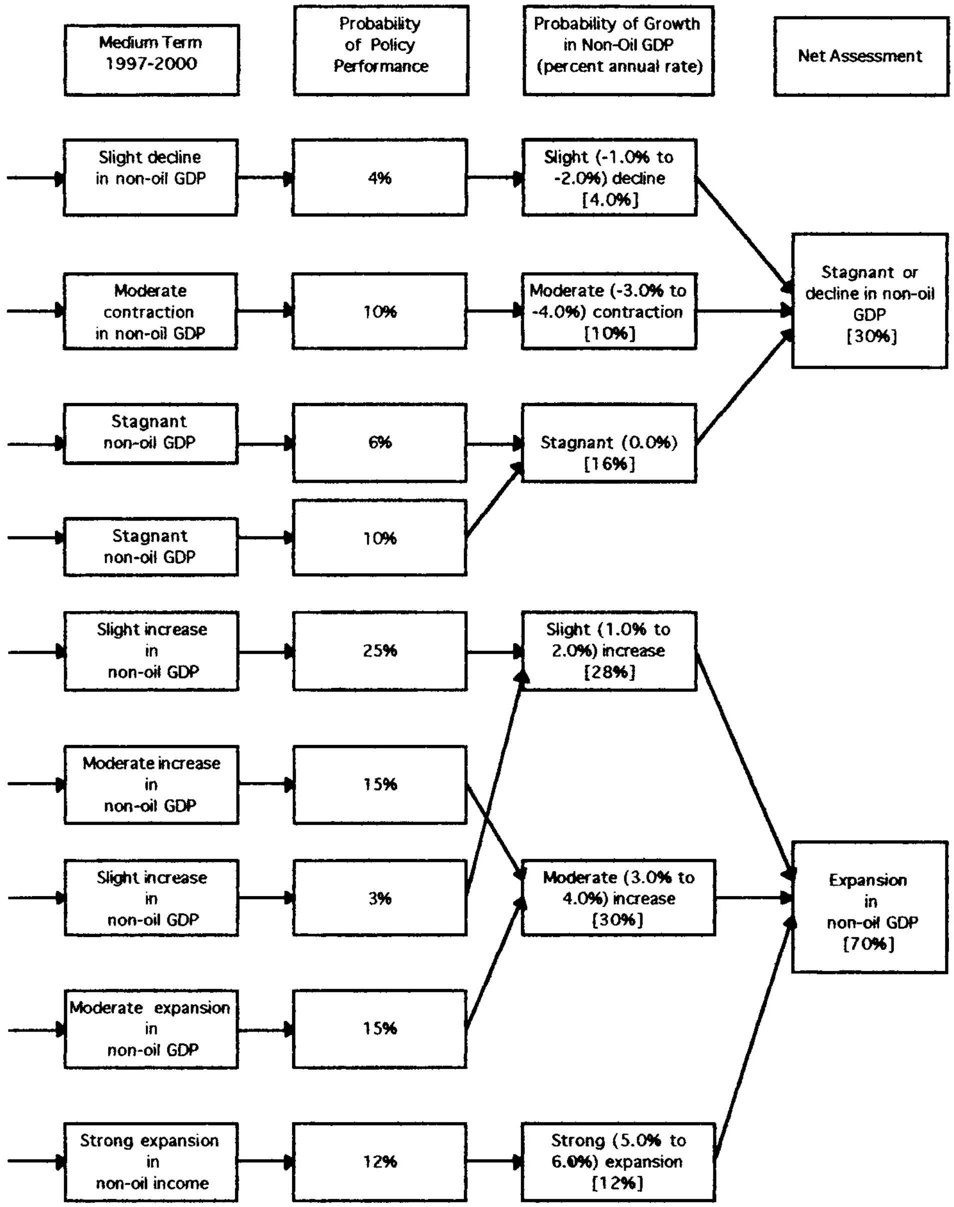
Figure 6
GCC States: Privatization Efforts

Country	Willing to Sell Major State Enterprises	Extent of Public Commitment	Open to Foreign Buyers	Interested in Buy, Operate, Transfer (BOT) Arrangements
Saudi Arabia	Yes	Cautious	No	
Bahrain	No		Yes	
Kuwait	Yes	Good	Probably, but with constraints	Yes
Oman	Yes	Strong		
Qatar	Probably, but no official statement			Possibly
UAE	Yes	Good	Probably Not	No

Figure 7
Saudi Arabia: Likely Economic Outcomes to the Year 2000



Note: (See page 56).



Medium Term 1997-2000
Probability of Policy Performance
Probability of Growth in Non-Oil GDP (percent annual rate)
Net Assessment
Slight decline in non-oil GDP
4%
Slight (-1.0% to -2.0%) decline [4.0%]
Moderate contraction in non-oil GDP
10%
Moderate (-3.0% to -4.0%) contraction [10%]
Stagnant or decline in non-oil GDP [30%]
Stagnant non-oil GDP
6%
Stagnant (0.0%) [16%]
Stagnant non-oil GDP
10%
Slight increase in non-oil GDP
25%
Slight (1.0% to 2.0%) increase [28%]
Moderate increase in non-oil GDP
15%
Slight increase in non-oil GDP
3%
Moderate (3.0% to 4.0%) increase [30%]
Expansion in non-oil GDP [70%]
Moderate expansion in non-oil GDP
15%
Strong expansion in non-oil income
12%
Strong (5.0% to 6.0%) expansion [12%]

Note:

(1) Oil Assumptions

As a member of OPEC, the kingdom faces three fundamental problems:

- the continuous increase in non-OPEC production;
- the disregard of OPEC quota compliance by certain members; and
- the reappearance of Iraqi oil on the world market.

All of these factors will force oil prices into an average range of US$16-17 per barrel.

(2) Policy Assumptions

Economic policies, largely aimed at reducing the twin current-account and fiscal deficit over forecast period, will be done without introducing new taxes or recourse to direct foreign borrowing. Deficit financing will mostly be with treasury bills and development bonds, with external borrowing as a last resort.